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Teri Frank. MW:CHI

David Bower, Senior Technical Reviewer
CC:INTL:2

[REDACTED]

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This memorandum briefly discusses the applicability of section 482 of the Internal Revenue Code to the facts in the [REDACTED]. This section 482 argument is not substantially different from the form over substance argument contained in the memorandum of April 12, 1991, from C. Ted Sanderson, CC:TL:Br2 ("Tax Lit. Memorandum").

FACTS:

[REDACTED] owned all of the stock of [REDACTED] which had [REDACTED] wholly-owned subsidiaries, [REDACTED] together owned all of the stock of [REDACTED] owned [REDACTED] % of the [REDACTED] stock. [REDACTED] owned all the stock of [REDACTED], a shell corporation. These corporations were part of an affiliated group that filed a consolidated return.

Prior to [REDACTED] [REDACTED] acquired the stock of [REDACTED]. On [REDACTED], [REDACTED] entered into an agreement to sell the [REDACTED] stock to an unrelated buyer. On [REDACTED], [REDACTED] dropped the stock of [REDACTED] down through its subsidiaries to [REDACTED]. The [REDACTED] stock was [REDACTED]'s only asset.

In [REDACTED], [REDACTED] distributed all of its [REDACTED] stock to [REDACTED] in redemption of [REDACTED]'s [REDACTED]

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stock.¹ For purposes of this memorandum it is assumed that when [REDACTED] redeemed its stock from [REDACTED] in exchange for the [REDACTED] stock (1) the fair market value of the [REDACTED] stock exceeded [REDACTED]'s basis in that stock, and (2) the fair market value of the [REDACTED] stock exceeded the fair market value of the [REDACTED] stock.

Immediately after the exchange, [REDACTED] sold all of its [REDACTED] stock at a loss to an unrelated party pursuant to the agreement executed prior to the exchange.

ISSUE:

Whether section 482 of the Code applies to treat [REDACTED] as if it had received consideration from [REDACTED] in an amount equal to the fair market value of the [REDACTED] stock that was redeemed.

LAW & ANALYSIS:

Section 482 of Code gives the Secretary authority to distribute, apportion or allocate gross income, deductions, credits or allowances between or among two or more organizations owned or controlled directly or indirectly by the same interests. Section 1.482-1(b)(1) of the Income Tax Regulations provides that the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. Section 1.482-1(c) of the regulations provides that the authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of its affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Section 482 was designed to correct distortions of income that may occur in transactions between related corporations though such transactions might not occur in similar form between unrelated taxpayers. Northwestern National Bank of Minneapolis v. United States, 556 F.2d 889,

¹ See the Tax Lit. Memorandum, pp.1-4, which concluded that the acquisition by [REDACTED] of its stock from [REDACTED] in exchange for the [REDACTED] stock was a redemption within the meaning of section 317 of the Code that would be governed by section 302(a) and (b)(3). Consequently, this transaction is treated as an exchange of property, for purposes of section 482, with respect to [REDACTED].

891-893 (8th Cir. 1977). In Northwestern National, section 482 was applied to a transaction that originated in a dividend distribution. See also Foster v. Commissioner, 80 T.C. 34, 149-150 (1983), aff'd on this issue, 756 F.2d 1430 (9th Cir. 1985). Section 482 therefore may be applicable to the transaction at issue, which originated in a redemption, although a redemption would not occur between unrelated taxpayers.

A section 482 adjustment is necessary in this case to correct a distortion of income that arose because [redacted] redeemed its stock and in exchange transferred to [redacted] stock, which had a lower fair market value than the [redacted] stock. [redacted] realized a loss upon the sale of its [redacted] stock to an unrelated third party. This loss was not a true economic loss for [redacted] because additional consideration that [redacted] should have received for its [redacted] stock remained in [redacted] after the redemption and [redacted] continued to indirectly own all of the [redacted] stock through its wholly-owned subsidiaries, [redacted]. In effect, common control was used to shift the excess value (i.e., the value of [redacted]'s holdings in [redacted] in excess of the value of the [redacted] stock that it received) to [redacted].

Section 482 applies to an exchange of property for less than adequate consideration between two corporations controlled by the same shareholder if the exchange results in a significant shifting of income or has as its principal purpose the avoidance of federal income tax. Rev. Rul. 69-630, 1969-2 C.B. 112.² In Rev. Rul. 69-630, A owned all of the stock of two corporations, X & Y. X sold property to Y for less than an arms length price. The sale resulted in a significant understatement of X's taxable income. Pursuant to section 482, X's income was increased to reflect the arm's length price of the property sold to Y and a corresponding adjustment was made to Y's basis in the property. The amount of the increase to X's income was then treated as a distribution by X to the controlling shareholder, A, and then as a capital contribution by A to Y.

² In Rev. Rul. 69-630 it was determined both that the bargain sale resulted in a significant shifting of income and that its principal purpose was to avoid income tax. Section 482 may be applied even when a transaction does not have as its principal purpose the avoidance of income tax but in that case Rev. Proc. 65-17, 1965-1 C.B. 833, as amended, will permit a qualifying taxpayer whose taxable income has been increased by reason of a section 482 allocation, to receive payment from the entity to whom the allocation was made without further tax consequences.

In this case, pursuant to section 482, [REDACTED]'s income should be increased by an amount equal to the difference between the fair market value of the [REDACTED] stock that was redeemed and the fair market value of the [REDACTED] stock transferred to [REDACTED] in the exchange. Under Rev. Rul. 69-630, [REDACTED] will be treated as if it received a distribution from [REDACTED] in the amount of this section 482 allocation, and [REDACTED] will be treated as if it received a capital contribution from [REDACTED] in this amount.

The section 482 allocation will cause [REDACTED] to recognize a gain on the redemption of its appreciated [REDACTED] stock. Because [REDACTED] is part of an affiliated group that files a consolidated return, this gain is not taken into account under section 1.1502-14(b) of the regulations until [REDACTED] ceases to be a member of the consolidated group. When this deferred gain is taken into account it will offset the loss that [REDACTED] realizes upon the sale of [REDACTED] to the independent third party.³

CONCLUSION:

In this case a significant shifting of income resulted when [REDACTED] redeemed its stock from [REDACTED] for less than fair market value. Section 482 provides authority to allocate income to [REDACTED] in a amount equal to the additional consideration [REDACTED] should have received for the [REDACTED] stock. The amount of this allocation will be treated as a distribution to [REDACTED] the controlling shareholder, and then as a capital contribution by [REDACTED] to [REDACTED].

If you have any questions concerning this memorandum, please call Valerie Mark at FTS 566-6645.

³ If assumption 1, on page 2, is not correct (i.e., if the fair market value of the [REDACTED] stock did not exceed [REDACTED]'s basis in that stock) then the additional income resulting from the section 482 allocation may merely reduce [REDACTED]'s loss on the redemption of its [REDACTED] stock.